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# Some Observations on China's Economic Transformation

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Vasant A. Sukhatme

*I*n recent months I have made several trips to the Wal-Mart store near my home, to purchase a smoke detector for the upstairs hallway, an electric iron, a no-frills DVD player, and a pump sprayer for use in our flower garden. Every item I purchased was made in China. The range of products coming out of China in recent years leads even a casual observer to sit up and take notice of the country where such products are made and understand the story behind its remarkable transformation from a poor, closed economy to a rising market-based economy over the past three decades. My participation in Macalester's recent Faculty Development International Seminar provided me with a great opportunity to visit China and increase my appreciation of its economic transformation.<sup>1</sup> This essay reports my understanding of the Chinese story. I have long taught and researched issues in economic development and tried to understand why some countries grow faster than others over long periods of time. My visit to China reinforced my concern and interest in this subject.

In an earlier era, Japan's economic rise after the Second World War was characterized as an economic miracle. Subsequently, in the 1970s and 1980s, the growth record of South Korea, Taiwan, Singapore, and Hong Kong came to be hailed as economic miracles. But the performance of all of these countries pales in comparison to China's growth record after its economic reforms of 1978. China is the economic miracle *par excellence*. China's economy grew at a more rapid rate for more years than any other country in all of recorded history. By all the usual

measures—real per capita income, life expectancy at birth, infant mortality rate, adult literacy rate, or the Human Development Index—the Chinese people are significantly better off than they were just three decades ago. Japan, South Korea, Taiwan, Singapore, and Hong Kong all grew by becoming more fully integrated into the world economy and by changing the institutional framework under which economic agents, including those in various levels of government, undertook decisions. So too has been the story of China.

The People's Republic of China was established in 1949 and the Communist Party moved very quickly to model its development strategy on the Soviet model (plan). By the mid-1950s, the public sector owned all the assets in the country; central planning and the accompanying price rigidities and allocation mechanisms were well in place; and the Communist Party had assumed complete control over all economic activity. State-owned enterprises were required to meet output and delivery goals set by the central authorities, and prices ceased to play any role in allocating resources among alternative uses. State investment was directed overwhelmingly to the industrial sector though, to be sure, the government did invest in inputs for agriculture, such as fertilizer and agricultural machinery. The development strategy was focused on developing heavy industry to achieve self-reliant growth and was inward looking; it was also divorced from the realities of a price system and involved extensive administrative controls on foreign exchange and credit. The outcome was inevitable and entirely predictable. In the mid-1970s, China remained very poor and by the end of the turbulent period of the Cultural Revolution (in the mid-1970s) it was clear to many within China that the country had fallen substantially behind its neighbors South Korea, Taiwan, Hong Kong, and, of course, Japan, who had all made rapid progress by greater reliance on the price system and the world economy. The first tentative steps toward economic reforms took place in 1978 and, since then, remarkable change has occurred that has transformed the lives of many hundreds of millions of its people.

The rest of this essay is organized as follows. Section I provides a broad overview of the transition process, along with the key dates when significant changes occurred. In Section II, I draw lessons from the Chinese experiment, the most important of which is that China was able to effect momentous change relatively smoothly and without much opposition from interest groups impacted by policy changes. Section III highlights some important challenges that face China.

## I. Phases of Reform

It has long been said that much of economics can be put in a simple sentence: people respond to incentives. Under the right reward structure, people and even government entities can work miracles. But the connection between economic policies and economic growth is not simple or direct; some kinds of economic policies can be *conducive* to economic growth while others can be *harmful* to it. There are many examples of countries in all parts of the world where bad policies have caused economic ruin. Bad policies create distortions that stand in the way of efficient resource use. These distortions mainly affect the *level* of economic activity and the resulting output, not its *rate of growth* over time. The rate of growth *is* affected as the economy moves from one level of activity to another. Policy changes do not generally influence *rates of growth*. That is not to say that the effects of policy reforms are not important; indeed, a series of policy reforms will add up to enormous consequences. This is precisely what happened in China, where the policymakers were willing to change the economic institutions in place for decades (for example, collectives in agriculture), and enabled the establishment of special economic zones in the southern and coastal areas, financed in large part by foreign direct investments.

In a broad sense, China's economic transformation has followed a "dual-track" system, which may well be the main reason behind its huge success. The dual-track system works as follows: (a) under the "plan track," agricultural communes or households or industrial firms are required to deliver specified amounts of output to government authorities (as established in the existing plans) at predetermined prices, and (b) under the "market track," these economic agents can sell their output on the open market at whatever price the output will fetch once they have satisfied their plan obligations. Further, under the dual-track approach, economic agents receive input allocations from plan authorities at pre-set input prices but may purchase additional amounts on the open market. Researchers have shown that as long as the pre-existing plan is feasible and continues to be enforced, the dual-track approach to market liberalization is efficient and Pareto-improving.<sup>2</sup>

The intuition behind this is straightforward: the introduction of a market track provides an opportunity for economic agents to become better off, and the maintenance of the plan track protects the status-quo rents under the existing plan. The maintenance of the plan track

provides stability and predictability while the market track provides incentives at the margin. This is also the reason why opposition to the dual-track approach is likely to be minimal at the start of reforms, and also why, once reforms have begun, there is likely to be minimal pressure to reverse the reforms. A dual-track system was established not only in agriculture, but also in industry and in the fiscal system.

Economic reform began with the Third Plenum of the 11th Communist Party Congress in December 1978 and has gone through several phases since then. The first reform was in agriculture in 1978. This was the first application of the dual-track approach and it signaled a significant reorientation in the strategy of economic development. The key administrative unit in Chinese collectivized agriculture was the commune. The central plan authority allocated inputs to each commune and determined what and how much should be produced. In return, the communes were obligated to deliver to the government specified quantities at predetermined prices. Policymakers had recognized early on the inefficiency of the system and concluded that existing price policies had created large disincentives in agriculture. To address these problems, the central government raised prices for mandatory deliveries and directed greater state investment into agriculture, thereby reducing the effective tax rate on agriculture. Simultaneously, and more importantly, the central government leadership allowed, even if somewhat reluctantly at the beginning, a greater degree of institutional flexibility by permitting the "household responsibility system" throughout large areas of the country. Under the household responsibility system, land that had been previously farmed collectively in communes was distributed equally to households (adjusting for size of household and age of its members) who obtained long-term use-rights to the land; households were then responsible for delivering specified amounts to the commune and could keep for themselves all additional output that they produced. This was effectively the de-collectivization of agriculture, a repudiation of the existing institutions in agriculture, and a return to private farming.<sup>3</sup> It is important to note that the household responsibility system arose at the commune level and not at the central government's initiative. In fact, the central government opposed the new institutional arrangement and even as late as 1982 continued to view the collective as the key to increasing agricultural output. In any event, once the household responsibility system became established in one part of the country, it quickly spread. There was an immediate impact on output and agricultural incomes.

The spectacular success in agriculture provided important support for reform in other sectors of the economy. Rising agricultural incomes would be spent on consumer goods and the availability of these goods had to increase, both by greater domestic production but also by imports. Increased domestic production of consumer goods also enabled the absorption of the growing labor force. The increased domestic output came from the establishment of new private enterprises as well as enterprises set up by local governments ("township and village enterprises," or TVEs). The TVEs were the mainspring of industrial reform and growth.

The dual-track approach was also adopted for industrial and manufactured products. In the pre-reform era, industrial enterprises were assigned output and delivery targets, just as was the system in agriculture. Industrial reforms first began on an experimental basis in Sichuan Province but quickly spread to other places. The key aspect of these reforms is that industrial enterprises were given significant autonomy in output and investment decisions but were not privatized (which is what had effectively occurred in agriculture). In the mid 1980s, state enterprises came to be subject to a "contract responsibility system." Each enterprise signed a contract with the relevant level of government (state or central, depending on control) under which the enterprise turned over a fixed annual tax and could retain any remaining profits. Enterprises were also given the discretion to sell any additional output, beyond the planned output, in the open market. These institutional changes paralleled the changes in agriculture.

At the time when economic reforms began, state-owned enterprises produced about 75 percent of the industrial output in the country and employed about 70 percent of all industrial employees. Since then the state sector has decreased considerably and now must compete with privately owned firms for resources and labor. Many small-sized state enterprises have been privatized, although the state has retained ownership of the large- and medium-sized firms. State-owned enterprises continue to be overstaffed and cannot easily get rid of excess workers. Their share of industrial output has fallen more sharply than their share of industrial employment.<sup>4</sup> Removing barriers to entry by domestic and foreign firms has promoted competition and raised productivity.

The "special economic zones" provide another application of the dual-track approach, even if the strategy of establishing these zones was "unbalanced" in the traditional sense in development econom-

ics. The government knew that these zones had the potential to create regional disparities but decided that the receipt of foreign funds and technology carried a bigger benefit in the long run. Indeed, the distinguished Chinese-American economist Gregory Chow noted that these special economic zones also served as experiments for skeptical Party members who were wary of foreign investments in China.<sup>5</sup> Ultimately, these zones were established because they lay outside the plan-track and did not affect planned production and allocation, and thereby were Pareto-improving. They also came to symbolize the new, open direction in China's economic development. China established four special economic zones in Shenzhen, Shantou, Zhuhai in the southern province of Guangdong, and Xiamen in Fujian province. The central government allowed a great deal of autonomy to the zones, such as the approval of foreign investment projects and also in terms of tax revenues generated in these zones. Firms in these zones were free to set their own wage and employment conditions and also received favorable tax treatment. These economic zones turned out to be very successful in attracting foreign investments, and by the late 1990s many other such zones had been established.

In the pre-reform era, the Chinese economy was characterized by low levels of monetization, not just because of the overall low level of economic development but because the economy had essentially no capital markets or labor markets or, for that matter, markets for intermediate goods such as steel or coal. Central planning, with its attendant allocation of inputs, had replaced the market. In such an environment, the banking system was state-owned and played a passive role in resource allocation. There were four large, specialized banks in this era: the People's Bank (which was both the central bank and also had commercial bank branches in various cities), the Agricultural Bank (which confined its commercial banking functions to the rural areas of the country), the Construction Bank (which managed the government's infrastructure construction projects), and the Bank of China (which focused on foreign exchange transactions). A little less than a decade after economic reforms had begun the government announced that China was to develop a complete market system in both labor and financial markets. Since then, enormous progress has occurred. The Shanghai stock exchange reopened in 1986 after having been shut down in 1949. The People's Bank became China's central bank in 1983, which, after some missteps in the mid-1980s, has matured as an independent institution charged with the conduct of monetary policy.

More than one-half of the total banking assets in China today are controlled by four commercial banks, all successors to the specialized banks mentioned above. All four have been privatized or are in the process of being privatized, and all have minority shares owned by U.S., Japanese, and European banks. China's entry into the World Trade Organization in 2001 has necessitated the restructuring of the four banks and has opened them up to foreign ownership.

The first phase lasted about fifteen years and saw the old system undergo a stunning transformation that changed the incentive structure and created competition over large segments of the economy. In the fall of 1992, Premier Deng Xiaoping undertook his famous "Southern Tour" to mobilize support for even greater reform. There has been even more profound change, including the formal endorsement by the 14th Party Congress in November 1993 of a socialist market economy as the end goal of transition. In the last decade there has been a greater emphasis on the coordination of reform measures; the Party has amended the Chinese constitution to put private business on the same footing as publicly owned businesses; and the Party has moved to create a rule-based market system. All of this has occurred in a one-party Communist state that has maintained political stability.

## **II. Lessons from the Chinese Case**

Unlike the situation in some other countries (India for instance), there was no crisis in China that required reform at that particular time. Living standards had grown steadily, if slowly, since the early 1950s and there were no acute economic problems. Nonetheless, the political leadership turned to reform "because they were seeking to deliver more of the rewards of economic growth to the Chinese people in order to solidify their political position."<sup>6</sup> After more than twenty-five years of economic reforms and spectacular growth over the entire period, it is clear that the reform process has been robust and steadily moving toward greater integration with the world. Scholars will debate whether the reform process was choreographed with a long-term vision of how it should unfold or even if there was a clear sense of reform objectives. Yet there can be little doubt that the reform process reflected a steady commitment to a market system, even if that was couched in phrases such as a "market system with Chinese characteristics." The early success with changing the reward and incentive



structure in agriculture reinforced the institutional change that lay at the heart of the Chinese transition.

As far as I can tell, however, China's reform history evolved piecemeal in the beginning, with no strong evidence that the reformers had already conceptualized in any detail a target system. Instead, the early reform measures were intended to address some specific malady in the existing economic institutions and incentive structures. Then these measures, especially when they resulted in quick successes and when they were seen as creating many gainers and few, if any, losers, in turn precipitated other reform measures. Inevitably, and not entirely unexpectedly, when unanticipated consequences arose the government put into place corrective measures. Important reforms, such as the establishment of special economic zones or the introduction of the household responsibility system in agriculture, were first introduced at local levels of government rather than at the central government. They rested on a crucial institutional feature of the economic and political governance structure that was federalism, Chinese style.<sup>7</sup> Numerous scholars have noted that the approach to reform reflected a Chinese saying meaning "crossing a river by groping the stones."

The overwhelming evidence from recent decades is that those countries that have moved up on the scale of economic prosperity have been more open to the rest of the world. The rapid growth of exports has characterized these successful countries. China is an outstanding example. China's early reforms were incremental, to be sure, but they were uniformly directed towards strengthening the "market track" while holding the "plan track" on a tight leash. The authorities were less inclined to design the "perfect" institution and proceeded with making changes to existing institutions incrementally; they were not hamstrung by the theory of the "second best" that posits that in an economy characterized by many economic distortions, the removal of any one distortion will not necessarily improve social welfare. However, even before the first decade of reform was over, the government had a fairly comprehensive view of both the road to reform and the target system at the end of the road.

### **III. Challenges for the Future**

China is a unique experiment in modern political economy. The evolution of its political system has lagged considerably behind its economic changes even as its transition to a modern market economy has come

a long way. This stands in sharp contrast to the situation in some Eastern European countries undergoing transition. But a transition is not a full event; it is a process. Nonetheless, there can be little doubt that, broadly speaking, the country's economic growth since reforms began has completely transformed the lives of its citizens, and its economy exhibits many of the features of a modern market economy. The Communist Party of China has certainly taken seriously its social contract to improve the lives of the population. Rural China has also undergone great transformation; grain output has increased significantly more rapidly than the country's population. There has been an impressive reduction in rural poverty. At the beginning of reforms more than 250 million people lived under the poverty line; this figure has now fallen to less than 40 million.

Despite all of these achievements, China's gross domestic product is still about one-ninth of United States' GDP. To provide some perspective on this comparative number, it is interesting to note that, in 1950, Germany's GDP was about one-fifth of U.S. GDP and Japan's GDP was one-eighth of U.S. GDP.<sup>8</sup> China was admitted to the World Trade Organization in 2001 after nearly a decade of preparation. Its tariffs and non-tariff barriers have come down considerably and the domestic prices of traded goods have moved gradually closer to world levels. The ratio of total trade to total output is now about 40 percent and China is more fully integrated into the world economy than ever before. However, the national average figure described above masks rather large differences in openness and trade orientation across provinces. The southern and eastern provinces are far more open, have received the bulk of foreign investments, and have prospered more as compared to the northwest and southwest provinces.

China's early reformers and its current leadership are still feeling their way, as they must, continuously adjusting and tweaking their pathway to a complete market-based system. Even if China is a special case—and in many ways it is special by virtue of its sheer size and its economic structure when it actually embarked on the path to reform—there are lessons to be drawn from its relatively successful evolution.

There is growing concern about income and wealth inequalities within urban areas, between urban and rural areas, and between the southern and coastal provinces (where a great deal of modernization has occurred) and the relatively less developed western and northern provinces. The Gini coefficient for China is estimated at about 0.42,

which is approximately in the middle of Gini values for countries at about the same level of real per capita income.<sup>9</sup> Even so, for purposes of internal political stability, the growing inequality has received attention at the highest levels of government. The government is investing more in the poorer areas and also in people in those areas, to enable them to make the transition to market-oriented labor markets.

Housing wealth is a major component of total wealth in urban China. There is some evidence that there is a housing bubble in the major urban areas. The government has moved in recent months to curb speculation in housing prices: it has raised the down payment requirements to 30 percent (from 20 percent) for apartments exceeding 90 square meters and it has raised the transactions tax on apartments that are sold within five years of purchase.

As noted above, an exciting transition is underway in China both in economic terms and in its political makeup. Everyone interested in world affairs should watch it with great interest. ●

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## Notes

1. The Macalester group traveled to Taipei (Taiwan), Nanjing, and Shanghai. I also traveled to Beijing to meet economists at Peking University. I am deeply grateful to Dr. Xu Li and Dr. Yang Wenhui for very fruitful discussions about the reforms in China and for their warmth and generosity. I learned much from them that I expect will inform my own teaching in the years ahead.
2. A change is Pareto-improving if it improves the existing situation for some people but does not make anyone worse off; see Lawrence J. Lau, Yingyi Qian, and Gerard Roland, "Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition," *Journal of Political Economy* 108, no. 1 (February 2003): 120–143.
3. The household responsibility system was an institutional innovation that arose at the grassroots level. A small group of farmers in a commune in Anhui Province is said to have first proposed the system well before it became widely adopted. It received quick approval by the provincial governor but the central government opposed it. See Justin Yifu Lin, Fang Cai, and Zhou Li, "The Lessons of China's Transition to a Market Economy," *Cato Journal* 16, no. 2 (Fall 1996): 201–231.
4. Xiao-Yuan Dong and Louis Putterman, "Soft Budget Constraints, Social Burdens, and Labor Redundancy in China's State Industry," *Journal of Comparative Economics* 31, no. 1 (March 2003): 110–133.
5. Gregory Chow, *China's Economic Transformation* (Malden, Mass.: Blackwell Publishers, 2002), p. 306.
6. Barry Naughton, *Growing Out of the Plan: China's Economic Reform 1978–1992* (Cambridge: Cambridge University Press, 1994), p. 61.

7. John M. Litwack and Yingyi Qian, "Balanced or Unbalanced Development: Special Economic Zones as Catalysts for Transition," *Journal of Comparative Economics* 26, no. 1 (March 1998): 1–25.
8. David Hale and Lyric Hughes Hale, "China Takes Off," *Foreign Affairs* 82, no. 6 (November–December 2003): 36–53.
9. The Gini coefficient is a convenient measure of the extent of inequality in an income distribution. It is based on how much income goes to particular segments of the income distribution. The data for the Gini coefficient come from the World Bank.